Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:BOS:TL-N-1652-01
CWMaurer

date:

to: Examination Division, Stoneham, MA

from: Associate Area Counsel(LMSB), Boston, MA

subject: [redacted]
Perpetual Policies and I.R.C. § 7872

This memorandum responds to an Email from Revenue Agent Michael Pratt dated February 22, 2001. This memorandum should not be cited as precedent.

Our assistance has been requested on the following issue:

ISSUE: Whether or not the Perpetual Policy Deposits held by Taxpayer are subject to the imputed interest rules of I.R.C. § 7872, and if so is Taxpayer subject to the penalty for failing to file information returns under section 6721.

CONCLUSION:

The Perpetual Policy Deposits held by Taxpayer are subject to the imputed interest rules of I.R.C. § 7872; Taxpayer may be subject to the penalty for failing to file information returns under section 6721, however, section 6724 provides an exception where such failure is due to reasonable cause and not to willful neglect.

FACTS

Taxpayer acquired a company engaged in the sale of a so-called "Perpetual Policy." The majority of the policies provide homeowners coverage on individual residences. Under these policies, rather than charging a traditional, annual premium for the coverage provided, the insurer requires the policyholder to make a refundable deposit in an amount determined based on the type of policy. No interest is paid to the policyholder on the deposit, but during the period Taxpayer holds the deposit the p-policyholder is not required to pay any annual premium on the policy. The policyholder may cancel the policy at any time and

receive a full refund of the deposit. Earnings from the investment of the deposits are treated by Taxpayer as investment income rather than premium income and are not tracked separately from other investments.

The company sales literature includes the following statement:

[redacted]

[redacted]. Taxpayer continues to sell this type of policy, but has entered into an agreement to sell this segment of their business to an unrelated third party. The sale is pending regulatory approval and should be completed by late [redacted] or early [redacted].

Taxpayer does not include the deposit amounts in unearned premiums. When a policy is cancelled a balance sheet entry is made crediting cash and debiting the deposit liability account. No Form 1099 is issued to the policyholder relating to the earnings on the deposit.

DISCUSSION

The issue under consideration was the subject of PLR 8831004 (May 5, 1988), and of PLR 8952001 (October 2, 1989), which revoked the earlier ruling.

I.R.C. § 7872 provides special rules for the imputation of interest on certain below-market loans. For purposes of section 7872, the term "loan" is interpreted broadly. Thus, any transfer of money that provides the transferor with a right to repayment may be a loan, including advances or deposits of all kinds. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 1018, 1984-3 C.B. Vol. 2 272.

Section 7872(c) describes various types of below-market loans to which section 7872 applies, including any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any federal tax. Section 7872(c)(1)(D). Tax avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision

to structure the transaction as a below-market loan, rather than as a loan requiring the payment of interest at a rate that equals or exceeds the applicable federal rate and a payment by the lender to the borrower. H.R. Rep. No. 98-861, at 1019.

Section 7872 may also apply to a below-market loan if the interest arrangements of such loan have a significant effect on any federal tax liability of the lender or the borrower. Section 7872(c)(1)(E). However, no transaction will be treated under the regulations as a "significant effect" loan earlier than the date that future regulations under section 7872(c)(1)(E) are published in proposed form. 1985-2 C.B. 812, 814.

PLR 8831004 (May 5, 1988) noted that the company under discussion had been issuing deposit-type policies since 1865, long before the current federal income tax was enacted in 1913. Accordingly, the District Office in that case agreed with the taxpayer that tax avoidance was not a motive for establishing the arrangement. However, the PLR notes that "The fact that the depository arrangement was initially structured without a tax avoidance motive does not mean the present arrangement will necessarily be so characterized for purposes of section 7872(c)(1)(D). The question to be resolved is whether X would have continued to market the arrangement in such manner without regard to the tax advantages." The PLR noted that the taxpayer's sale of such policies since 1865 was a "compelling factor" in its favor that the arrangements were not motivated by tax avoidance, and accordingly agreed with the District Office that section 7872(c)(1)(D) did not apply.

The PLR agreed that the depository arrangement appears to be a "significant effect" loan, but concluded that the deposit will not be subject to section 7872(c)(1)(E) earlier than the date that future regulations are published.

PLR 8952001 (October 2, 1989) revoked the earlier ruling. Additional material was included in the PLR describing the taxpayer's sales literature. In its analysis, the ruling stated:

> A deposit with X by a ***** may be classified under section 7872(c)(1)(D) of the Code as a tax-avoidance loan from the standpoint of either X or its *****. X recognizes that low prices attract customers. Thus, its sales literature compares the "real cost" of X's product, exclusive of federal tax, with the higher prices of its competition. Such cost comparisons inevitably favor X because a competitor's price includes the federal tax on the income used to purchase the services.

> Therefore, to X as a seller of ***** or to the ***** purchaser ***** avoidance of federal tax on interest income is a principal factor in the sale or purchase *****. Without tax avoidance, the potential price advantage enjoyed by X's product is substantially diminished. On the other side of the transaction, tax avoidance permits the *****/purchaser more ***** than a similarly situated ***** using after tax dollars -- clearly an important consideration in the decision of which ***** company to patronize.

Accordingly, PLR 8952001 concluded that the deposit is a loan subject to section 7872, and that a principal purpose of the interest arrangement of the loan is the avoidance of federal tax. The previous ruling, PLR 8831004, was revoked.

Penalties. Proposed Regulation § 1.7872-11(g)(4) provides that all amounts imputed under section 7872 are characterized in accordance with the substance of the transaction and are treated as so characterized for all purposes of the Code. Accordingly, all applicable information and reporting requirements (e.g., reporting on Form W-2 and Form 1099) must be satisfied. Section 6049(a) requires every person who makes payments of interest aggregating $10 or more to any other person to file an information return setting forth the amount of such payments and the name and address of the person to whom paid. Section 6721 imposes penalties for failure to file correct information returns. However, section 6724 provides that no penalty shall be imposed with respect to any failure if it is shown that such failure is due to reasonable cause and not to willful neglect. Determination of willful neglect is generally a factual matter. The information available is not conclusive. We believe the legal principal whether section 7872 applies is well-supported. However, there does not appear to have been any litigation on the subject. No specific regulations have been issued. The only published authority is a private letter ruling, which revokes an earlier ruling that had reached the opposite conclusion. It appears clear that these types of policies originated at a time when tax considerations were not a motivation. The determination that section 7872 applies depends upon a determination that tax advantages are now a principal purpose for the continuation of this type of policy. This too is a factual issue. Given the factual and disputed nature of the legal issue, it may be

questioned whether Taxpayer should be subjected to the reporting penalty.

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(Large and Mid-Size Business)

By: _____
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